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Expert Analysis

The DOJ's Challenge To the AT&T/Time Warner Deal

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Our previous column explored the implication of the apparent tension between President Donald Trump's populist predilections to antitrust enforcement and the generally conservative antitrust philosophy of his appointee to the Antitrust Department of the Department of Justice (DOJ), Makan Delrahim, highlighting that the DOJ's approach to the AT&T/Time Warner merger should be informative in assessing the enforcement direction of the Antitrust Division. (Shepard Goldfein and James Keyte, "Trump's Antitrust Enforcers: Limited Intervention Remains the Most Likely Approach," New York Law Journal (Nov. 13, 2017)). And now the speculation is over: Contrary to our speculation, the DOJ on Nov. 20 filed suit to block AT&T/DirecTV (AT&T)'s proposed acquisition of Time Warner Inc. In the complaint, the DOJ alleges that the merged company would substantially lessen competition and harm consumers by attempting to foreclose Time Warner content to AT&T's rival distributors or raise the prices they need to pay to carry such content. In particular, the DOJ alleges that the merged company would deploy such strategy to impede emerging and growing rivals, such as online distributor Sling TV. What follow are the key issues the U.S. District Court for the District of Columbia is likely to consider in assessing the DOJ's antitrust case against AT&T/Time Warner.

> The AT&T/Time Warner case presents a wealth of issues unique to vertical mergers that the court likely will have to resolve.

Ability to Foreclose Access to Content or Raise Rivals' Costs. The DOJ's vertical theory of harm is predicated on the notion that by withholding Time Warner content or raising its prices, the merged company would disadvantage AT&T's rival distributors, resulting in their loss of subscribers, some portion of which would be recaptured by the combined company. But, critically, in order to assess the combined company's *ability* to carry out such a strategy, the court will likely have to examine AT&T and Time Warner's "market power" in their respective "markets" (in the antitrust sense of the word). In concrete terms, the court must determine whether Time Warner's popular content, like HBO and CNN, is sufficiently strong to cause subscribers not to

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switch to other networks in the face of hypothesized higher fees. (And, of course, the court would have to determine if such a price discrimination strategy is feasible in that it may be difficult for the merged company to identify, in advance, the number of "marginal" consumers who would be more inclined to just switch to alternative products if prices were raised.).

The DOJ alleges that Time Warner's Turner networks, with its portfolio of valuable live sports, live news and entertainment content, have "market power" and that there are "few equally important and popular substitutes for these networks." Complaint, *United States v. AT&T*, Civ. No. 1:17-cv-02511 (RJL) (D.D.C. filed Nov. 20, 2017), ¶24 (Complaint). The DOJ similarly alleges that Time Warner's HBO has market power. As alleged, this is "must have" content[1] that "video distributors that do not carry them risk losing a substantial number of current and potential subscribers to rival MVPDs (multichannel video programming distributors) and virtual MVPDs that do." Complaint, ¶24.

While the DOJ cites AT&T and Time Warner's internal documents that describe the Turner programming as owning "must have" or "must carry" content (Complaint, ¶¶4, 24), the court will have to assess the evidence in the context of §7 of the Clayton Act's substantive requirements. For example, the court will assess the extent of the substitution possibilities for the Turner networks and HBO on the one hand and other networks on the other, including subscription video on demand services (SVODs) such as Netflix and Amazon Prime. The question will be as follows: If, post-merger, Turner networks become unavailable or their prices substantially increase, what proportion of subscribers would likely switch to watching Netflix and Amazon Prime or other arguably "must have" content? As a case in point, defendants in their joint answer cite Google's YouTube TV as an example of successful alternative to traditional pay-TV service that launched without including any Time Warner networks, including Turner. This may contravene the DOJ's claim that Turner programming provides Time Warner with the type of §7 market power that would be necessary to engage in a foreclosure strategy.

Economic Incentive to Foreclose Access to Content or Raise Rivals' Costs. If the government clears the threshold issue of whether the merged company would have the *ability* or the market power to raise rival distributors' costs or foreclose their access to Time Warner's programming content, the court will inevitably have to assess whether the merged company would have the economic *incentive* to engage in such conduct. This is a key issue, as §7 of the Clayton Act—which prohibits acquisitions where "the effect of such acquisition may be substantially to lessen competition, or to tend to create a monopoly"—is in essence a predictive undertaking: would the anticompetitive conduct in question make economic sense for the merged company actually to carry out?

Regarding a strategy of complete foreclosure, the court will assess whether Time Warner's anticipated lost profits from foreclosing the supply of its content to AT&T's rival distributors would be overcome by the additional profits made on subscribers who switch to AT&T's distribution services (the latter depending on the number of subscribers that would switch to AT&T and AT&T's variable margin on each new subscriber). Time Warner's lost profits from foreclosing may indeed be significant, inferred from how much AT&T is *paying* to obtain those profits through the merger. Given that fewer than 15 percent of home-video subscription are on networks owned by AT&T (DirecTV, U-verse, and DirecTV Now), a significant portion of AT&T's $85 billion purchase price for Time Warner ($36 billion according to an estimate) is fairly attributed to the portion of Time Warner's revenue that comes from fees that AT&T's *rival* distributors pay to carry its content (which profits will be lost under the foreclosure strategy).[2] The court will then assess whether the resulting gains—winning new subscribers who switch to AT&T or driving its competitors out of business—are sufficiently likely and substantial to offset the anticipated loss of revenue for which it appears to be paying a hefty sum of money.

While raising rivals' costs is a more nuanced strategy—affecting the marginal costs of rivals' rather than the availability of the content itself—the court will likely also consider empirical data and economic analysis to assess the incentives for that strategy. What, for example, would the likely price increase to rivals be and how would it affect their ability to be competitive? Will the court require evidence that, post-merger, rivals would be driven below their "minimum efficient scale," a standard many advocate as a proxy for consumer harm? Matter of McWane, Docket No. 9351 (F.T.C. Feb. 6, 2014), at 10-11 (dissenting statement of Commissioner Joshua D. Wright). In addition, the court may consider relevant past and ongoing practice of the parties and whether the merger will change their incentives. For instance, Time Warner itself is already vertically integrated—it both produces content and distributes it through channels such as HBO, the CW and TB. (Manne, supra note 2). One may posit that if raising prices for bundled content made economic sense, Time Warner would have already done so. At a minimum, the court will likely assess Time Warner's past pricing behavior, and determine whether the calculus changes once AT&T owns Time Warner.

Another issue that may become relevant to the analysis of price effects is the defendants' assertion that Time Warner has extended to third-party distributors a seven-year arbitration protection contingent on the closing of the merger, which the defendants claim is of the same sort that the DOJ embraced in clearing the vertical merger involving Comcast and NBCUniversal in 2011. Answer, *United States v. AT&T*, Civ. No. 1:17-cv-02511 (RJL) (D.D.C. filed Nov. 28, 2017), ¶ 8 (Answer). The defendants point to this remedial offer as "clear proof that, when it is owned by AT&T, Turner will have no greater incentive to increase the price of Turner Networks." Answer, ¶9. The court may consider whether the contractual terms are sufficient to demonstrate the lack of the merged company's incentive to raise rival distributors' costs or, if reduced to an actual deal term, the parties may litigate the "fix" as has been done in prior §7 cases.

Ability and Incentive for Oligopolistic Coordination. A separate theory of harm the DOJ alleges is that the merger would increase the likelihood of "oligopolistic coordination," particularly among large, vertically integrated MVPDs such as Comcast/NBCU. Although the DOJ's complaint does not fully spell out the nature of such coordination, it appears to envision a coordination that seeks "stability… at the cost of competition" that would work to impede competition from emerging, innovative online competitors. Complaint, ¶41.

As discussed above, here, too, the court would assess whether the combined company will have both the ability and incentive to facilitate coordination with other vertically integrated MVPDs. To carry out this analysis, the court may consider, in light of the horizontal merger guidelines: increase in market concentration; evidence a market is vulnerable to coordinated conduct (such as evidence of previous express collusion and evidence that terms offered to customers are relatively transparent); and evidence that the merger may enhance that vulnerability. Section 7.1., Horizontal Merger Guidelines. With these highly differentiated products and firms, this may be a difficult task for the DOJ.

Effect of the Merger on the Overall Consumer Welfare. If the DOJ succeeds in showing that the merged company will have the ability and incentive to raise rivals' costs or foreclose access to Time Warner content, or engage in an oligopolistic coordination, the last step in the court's analysis would be to determine whether the probable *net* effect of the merger would be harmful to consumers. To do so, the court would have to weigh any procompetitive rationale or likely effects from the merger against any likely, anticompetitive effects it finds. This is not an easy task, especially in an ongoing and rapidly evolving media environment (both as to content creation and distribution). For example, a well-known benefit that may arise from a vertical integration is the elimination of "double marginalization," which typically is thought to lead to lower prices and expanded distribution. Double marginalization occurs when two or more firms in a vertical supply chain relationship, which have some degree of market power in their respective markets, apply their own markups in prices. Double marginalization may be eliminated when a merged firm instead applies a single markup that is lower than the double markups, yet is still profit maximizing. In their joint answer, the defendants list other benefits the court may consider, such as driving innovation in video content and distribution, and using AT&T's consumer data to improve Time Warner's production and marketing of new content and to increase the value of advertising. Answer, ¶6. The court will assess the likelihood and magnitude of such efficiencies, and whether they are merger-specific.

Finally, the court will also have to grapple with the assertion that even complete foreclosure—i.e., exclusivity—may benefit consumers in the longer term: even if exclusivity deals appear to limit distribution, they may spur the creation of new content and new modes of distribution as evidenced by the emergence of Netflix, Amazon Prime and Sling TV. (Manne, supra note 2). Arguably, such benefits are demonstrable in a media environment where there are no apparent structural barriers to entry; at a minimum, it will be an interesting question for the court.

What the DOJ Challenge Means. Irrespective of whether the DOJ's case against the merger reveals the influence of President Trump's economic populism—or is just cutting edge antitrust enforcement—the AT&T/Time Warner case presents a wealth of issues unique to vertical mergers that the court likely will have to resolve. In this respect, the case is a much-needed opportunity for the court to provide guidance on vertical mergers and foreclosure theory generally, and no doubt will have significant influence on future deal making and enforcement actions for years to come.

1. It is worth noting that, although the concept of "must have" content is arguably related to an essential facilities-type doctrine, that theory was effectively debunked in Verizon Communications Inc. v. Law Offices of Curtis V. Trinko, 540 U.S. 398 (2004).

2. In an article published in the Wall Street Journal, Geoffrey A. Manne estimates the value to AT&T of the portion of Time Warner's business that comes from AT&T's competitors at $36 billion, based on the following calculation: The author estimates that more than half of Time Warner's revenue comes from fees that distributors pay to carry its content. And assuming that 15 percent of those fees come from AT&T networks, AT&T must value the portion of Time Warner's business that comes from AT&T's competitors at $85 billion x 50 percent x (100 percent – 15 percent) = $36 billion. Geoffrey A. Manne, "There's No Antitrust Case Against AT&T," Nov. 21 2017 6:22p.m. ET, The Wall Street Journal.